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In the Supreme Court of the United States

OCTOBER TERM, 1994

C. STEPHEN BABIN AND BETTY BOEHM BABIN,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a partner may apply his share of a partnership's income from the discharge of indebtedness to increase his adjusted basis in the partnership even though, due to his insolvency, he did not recognize or pay tax on the partnership's income from the discharge of indebtedness.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	5
Conclusion	10

TABLE OF AUTHORITIES

Cases:

Adickes v. *S.H. Kress & Co.*, 398 U.S. 144 (1970)	10
City of Springfield v. *Kibbe*, 480 U.S. 257 (1987)	10
Estate of Delman v. *Commissioner*, 73 T.C. 15 (1979)	7, 8, 9
Estate of Newman v. *Commissioner*, 934 F.2d 426 (2d Cir. 1991)	5, 8, 9
Gershkowitz v. *Commissioner*, 88 T.C. 984 (1987)	6
United States v. *Kirby Lumber Co.*, 284 U.S. 1 (1931)	5
United States v. *Williams*, 112 S. Ct. 1735 (1992)	10
Taylor v. *Freeland & Kronz*, 112 S. Ct. 1644 (1992)	10

Statutes:

Bankruptcy Act, Ch. 12, 11 U.S.C. 1201 *et seq.*	2
Internal Revenue Code (26 U.S.C.):	
§ 61(a)(12)	3, 5, 6
§ 108(a)(1)(B)	5
§ 702(a)	6
§ 704(d)	6
§ 705(a)	4, 7, 9
§ 705(a)(1)	6
§ 705(a)(1)(A)	3, 8, 9
§ 705(a)(1)(B)	9
§ 722	5
§ 731	3
§ 731(a)	6, 7
§ 733	6, 7

Statutes—Continued:

	Page
§ 741	3, 6, 7
§ 752(b)	3, 6, 7

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-18a) is reported at 23 F.3d 1032. The decision of the Tax Court (Pet. App. 21a-56a) is reported at 64 T.C.M. (CCH) 1357.

JURISDICTION

The judgment of the court of appeals (Pet. App. 19a-20a) was entered on May 6, 1994. A petition for rehearing was denied on July 7, 1994 (Pet. App. 1a-2a). The petition for a writ of certiorari was filed on August 4, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner C. Stephen Babin was a general partner in Lakewood Center Medical Construction Associates (LCMCA). He held a 51% interest in the income and losses of LCMCA and a 75% interest in its assets and liabilities (Pet. App. 4a). LCMCA's primary asset was a medical building which had been financed by a loan of more than $4 million from Cleveland Trust Company (*id.* at 23a). Largely as the result of this borrowing, petitioner's basis in LCMCA was originally $3.9 million (*id.* at 50a). His basis in the partnership was thereafter reduced to approximately $2.6 million, however, by his share of recurring partnership losses (that he was permitted to deduct against his individual income over the years) and by a cash distribution from the partnership (*ibid.*).

When LCMCA became unable to make required payments on its loan from Cleveland Trust, the bank foreclosed on the medical building. LCMCA then filed a petition under Chapter XII of the Bankruptcy Act. While that bankruptcy proceeding was pending, LCMCA reached an agreement to sell all of the partnership's assets—including the medical building—for $2,850,000. As part of the sale agreement, Cleveland Trust agreed to accept $2,750,000 from LCMCA in complete satisfaction of its outstanding debt and interest, thereby forgiving $2,420,019 of indebtedness. The bankruptcy court approved this settlement and dismissed the bankruptcy proceeding (Pet. App. 4a-5a, 23a).

2. In 1989, the Internal Revenue Service issued a notice of deficiency concerning certain income that petitioner failed to report from the transactions involving LCMCA (Pet. App. 5a). As is relevant here, the Service determined (i) that petitioner's 75% share of the dis-

charge of LCMCA's indebtedness upon the sale of its assets represented a deemed distribution to him of $3,982,514 under 26 U.S.C. 752(b), (ii) that this distribution exceeded petitioner's adjusted basis in LCMCA of $2,663,180, and (iii) that petitioner therefore recognized a capital gain of $1,289,334 from this transaction under 26 U.S.C. 731 (Pet. App. 5a).

3. Petitioner sought a redetermination of the deficiency in Tax Court, contending that he had no income from the discharge of indebtedness (Pet. App. 21a-22a). He argued first that, because he was insolvent both before and after the discharge of indebtedness, he was entitled to the benefit of the "insolvency exception" from the general rule (26 U.S.C. 61(a)(12)) that requires a discharge of indebtedness to be recognized as income. He further claimed that, under Section 705(a)(1)(A) of the Internal Revenue Code, 26 U.S.C. 705(a)(1)(A), he was entitled to apply his share of the partnership's discharge of indebtedness to increase his adjusted basis in LCMCA, thereby substantially reducing the capital gain that resulted from the deemed distribution under Section 752(b) (Pet. App. 50a).

The Commissioner of Internal Revenue argued in Tax Court that petitioner was not insolvent and was therefore required to recognize his share of the partnership's discharge of indebtedness as ordinary income. Alternatively, the Commissioner contended that, if petitioner was not required to recognize his share of the partnership's discharge of indebtedness income because he was insolvent, then petitioner could not apply that discharge of indebtedness to increase his adjusted basis in the partnership. As a result, petitioner remained liable for the entire amount of the capital gain resulting from the deemed distribution to him from the elimination of the partnership's liabilities (Pet. App. 49a-51a).

Pursuant to an agreement of the parties (Pet. Tax Ct. Br. 35-36; Resp. Tax Ct. Br. 18), the Tax Court applied the insolvency exception at the partner level. Following an evidentiary hearing, the Tax Court found that petitioner was insolvent both before and after the partnership transaction. The court therefore concluded that petitioner was entitled to the insolvency exception and did not have to recognize a share of the partnership's discharge of indebtedness income (Pet. App. 49a). The court agreed with the Commissioner, however, that petitioner could not increase his adjusted basis in LCMCA under Section 705(a) by the amount of his unrecognized share of the partnership's discharge of indebtedness income (Pet. App. 51a). The Tax Court therefore upheld the Commissioner's determination that petitioner was liable for tax on the full amount of his gain from the elimination of LCMCA's liabilities (*i.e.*, the amount by which his share of those liabilities exceeded his adjusted basis in the partnership).

4. The court of appeals affirmed (Pet. App. 3a-18a). The court held that, because petitioner was insolvent, he did not receive a distributive share of the partnership's discharge of indebtedness income (*id.* at 10a) and therefore "is not permitted to increase the adjusted basis of his interest in the Partnership" (*id.* at 11a). The court rejected petitioner's argument that this result negates the benefit that petitioner is to receive from the insolvency exception. The court noted that petitioner received the benefit of the exception by not recognizing his share of the discharge of indebtedness as ordinary income. The court further noted that, if petitioner were allowed to increase his adjusted basis by the unrecognized discharge of indebtedness income, this would permit him to "avoid tax on the deemed distribution of money to him of his interest in the liabilities that he

previously used to increase his adjusted basis" (*id.* at 14a). The court "refuse[d] to sanction such a windfall to petitioner" (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. a. It is well established, as a general rule, that a debtor realizes taxable income upon the discharge or cancellation of indebtedness. 26 U.S.C. 61(a)(12); *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931). An exception to this general rule, however, is the so-called "insolvency exception." Under that judge-made exception, an insolvent debtor is deemed not to have realized income from the discharge of indebtedness if he remains insolvent after the discharge. See, *e.g.*, *Estate of Newman* v. *Commissioner*, 934 F.2d 426, 430 (2d Cir. 1991). [1]

The insolvency exception is relatively easy to apply in the ordinary case. With respect to the discharge of a debt owed by a partnership, however, application of the exception is complicated by the special rules governing the taxation of partners and partnerships. When a partnership assumes a liability, a partner's basis in the partnership is correspondingly increased because the liability is treated as if it were a contribution of money by the partner to the partnership. 26 U.S.C. 722. This increase in basis is significant because the deduction of a partner's share of partnership losses on the partner's

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[1] This exception was codified in Section 108(a)(1)(B) of the Internal Revenue Code, effective for transactions occurring after December 31, 1980, subsequent to the tax year at issue in this case. 26 U.S.C. 108(a)(1)(B).

individual income tax return is permitted only to the extent of his adjusted basis in his partnership interest. 26 U.S.C. 704(d). When a partnership incurs a debt obligation, the partners are thereby enabled to deduct losses in excess of their actual contributions of cash or other property to the partnership.

The provisions of the Internal Revenue Code, however, seek to ensure that a partner does not increase his basis in a partnership by the amount of a liability for which he is not truly liable. When a partnership debt is discharged, the resulting decrease in a partner's share of the partnership's liabilities is therefore treated as a deemed distribution to the partner (26 U.S.C. 752(b)) and his basis in the partnership is correspondingly reduced (26 U.S.C. 733). The partner must recognize gain—treated as gain from the sale or exchange of the partnership interest—if, and to the extent that, the deemed distribution exceeds his adjusted basis. 26 U.S.C. 731(a), 741.

Separate from these rules governing basis adjustments are the rules governing the tax effect of a discharge of indebtedness. As noted above, under Section 61(a)(12), discharge of indebtedness represents income to the partnership which (under Section 702(a)) a partner ordinarily must recognize in reporting his individual income tax liability. When that occurs, the partner's basis in his partnership interest is increased (under Section 705(a)(1)) by the amount of taxable income allocated to him under Section 702(a).

These two sets of provisions "operate independently and simultaneously." *Gershkowitz* v. *Commissioner*, 88 T.C. 984, 1008 (1987). Taken together, they provide that, when a partner recognizes discharge of indebtedness income, the increase in his basis in his partnership interest (under Section 705(a)(1)) offsets the decrease in

basis (under Section 733) resulting from the deemed distribution to him attributable to the reduction in partnership indebtedness (under Section 752(b)). The result is that (i) the partner recognizes his distributive share of the partnership's discharge of indebtedness income, (ii) there is no net change in his basis in the partnership as a result of the discharge of indebtedness, and (iii) there is no capital gain to the partner under Section 731(a).

b. As the court of appeals recognized (Pet. App. 10a-11a), however, the effects on a partner of a discharge of partnership indebtedness are different when the insolvency exception applies. When a partner qualifies for that exception, he recognizes no income from the cancellation of the indebtedness (*id.* at 8a-9a). This benefits the partner by permitting him to avoid taxation on his share of the discharge of indebtedness income as ordinary income. The basis adjustments discussed above resulting from discharge of indebtedness income received by a partnership, however, occur only when a partner recognizes a share of that income. As the court of appeals ruled in this case (*id.* at 10a-11a), petitioner may not increase his basis in the partnership pursuant to Section 705(a) by his "share" of the partnership's discharge of indebtedness income because he is deemed (by the "insolvency exception") never to have received such a share.

The court's conclusion is correct. Because the insolvency exception applies in this case, no income has been realized by petitioner from the discharge of the partnership's indebtedness. See, *e.g.*, *Estate of Delman* v. *Commissioner*, 73 T.C. 15, 32 (1979) ("The theory of this exception is that *no accession to income has occurred* if after the debt cancellation, the taxpayer remains insolvent." (emphasis added)). To the extent

that the insolvency exception applies, the discharge of indebtedness is not "income" to petitioner for purposes of the Internal Revenue Code. Because he thus did not receive a distributive share of that income of the partnership, he is not permitted to increase his adjusted basis in the partnership under Section 705(a)(1)(A).

c. The insolvency exception is limited to the recognition of ordinary income upon the discharge or cancellation of indebtedness. It does not eliminate income earned from services or gain from the sale or exchange of property. Similarly, it does not apply to permit a partner to eliminate the capital gain realized from the deemed distribution to partners resulting from a reduction of partnership liabilities. See *Estate of Delman* v. *Commissioner*, 73 T.C. at 32 ("The insolvency exception applies only for cancellation of indebtedness income. For all other types of income, such as * * * gains from dealings in property, the solvency of the taxpayer is irrelevant.").

Petitioner's proposed, contrary application of the insolvency exception would produce illogical results. Under petitioner's theory, the insolvent partner would not only avoid tax on his share of the partnership's ordinary income from discharge of indebtedness, he would also increase his basis in the partnership as if a share of that income *had* been attributed to him. Petitioner thus seeks to capitalize an amount of partnership liabilities for which he was ultimately not liable, to deduct operating losses far in excess of his actual contributions to the partnership, and then to avoid recognizing the gain realized when the partnership liabilities are canceled. The courts of appeals have correctly recognized the abusive nature of petitioner's theory and have rejected it. See Pet. App. 17a-18a; *Estate of Newman* v. *Commissioner*, 934 F.2d at 433-434.

d. Petitioner argues that the decision in this case "directly contradicts the plain * * * language of 26 U.S.C. § 705(a)" (Pet. 7). That statute specifies that a partner's basis is to be increased by his "distributive share" of the "taxable income of the partnership" and the "income of the partnership exempt from tax" (26 U.S.C. 705(a)(1)(A) and (B)). As the court of appeals noted (Pet. App. 10a-11a), however, because of the application of the insolvency exception, petitioner simply did not receive any "distributive share" of the partnership's discharge of indebtedness income. There is thus no "income" to which Section 705(a) can apply. See *Estate of Delman* v. *Commissioner*, 73 T.C. at 32 ("no accession to income has occurred").

Contrary to petitioner's contention, this conclusion does not result in a "second level of taxation" (Pet. 8 n.3). Because of his insolvency, petitioner is not subject to tax on the partnership's discharge of indebtedness income. It is only the gain that he has realized from the elimination of his share of LCMCA's liabilities, which is entirely separate from the discharge of indebtedness income, that is subject to tax. As the court of appeals noted (Pet. App. 13a-14a), petitioner has thus received the full benefit of the insolvency exception.

2. Petitioner errs in contending (Pet. 13) that the decision in this case conflicts with *Estate of Newman* v. *Commissioner*, *supra*. In *Estate of Newman*, the Second Circuit applied the insolvency exception at the partnership level rather than (as in this case) at the partner level. See 934 F.2d at 432. In the present case, by contrast, the parties agreed that the insolvency exception should be applied at the partner level. Neither the Tax Court nor the court of appeals ruled on that question. See Pet. App. 8a-9a, 33a-34a. The question whether, in these circumstances, the insolvency

exception should be applied at the partner or the partnership level is therefore not properly presented for review by this Court in this case.[2] See *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 147 n.2 (1970) ("Where issues are neither raised before nor considered by the Court of Appeals, this Court will not ordinarily consider them."). Accord, *United States* v. *Williams*, 112 S. Ct. 1735, 1738 (1992); *Taylor* v. *Freeland & Kronz*, 112 S. Ct. 1644, 1649 (1992); *City of Springfield* v. *Kibbe*, 480 U.S. 257, 266 (1987).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[2] Moreover, this issue would have relevance to petitioner's claims only if it had been determined that the insolvency exception was *not* applicable. In this case, however, both the Tax Court and the court of appeals concluded that the insolvency exception does apply to petitioner (Pet. App. 9a, 49a). Petitioner simply disagrees with the courts below concerning the effect of the insolvency exception in the context of a partnership's discharge of indebtedness.